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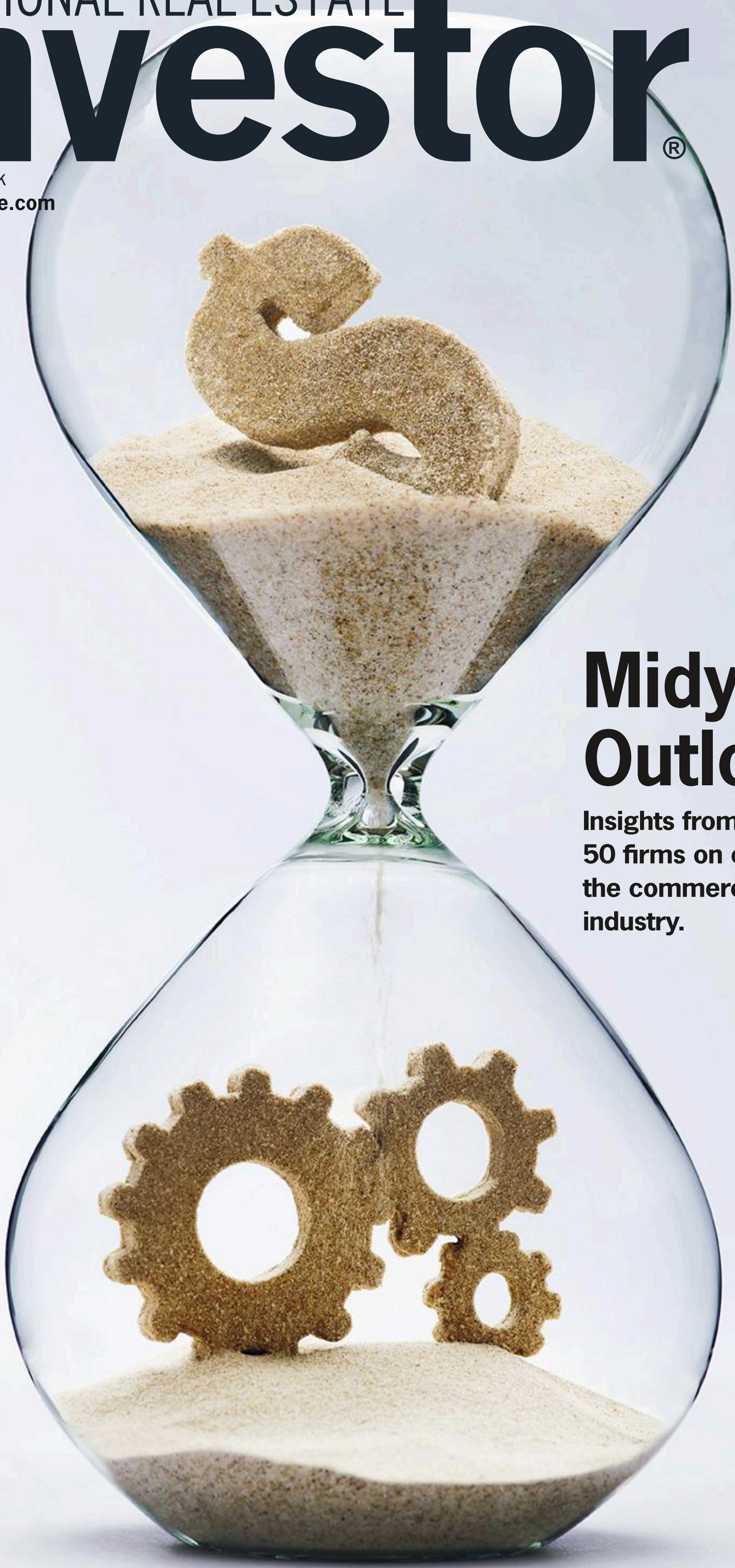

Midyear Outlook

Insights from more than 50 firms on every aspect of the commercial real estate industry.

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Institutional Equity Investing–Art or Science?

By **Jon Dishell**

A great leader once mentored me, "Equity is the mother's milk of all real estate investing." While this may be obvious, the methodologies attendant to its utilization, like the investment cycles it serves, come in a variety of forms which have changed over the decades as real estate has become an accepted asset class.

The nature of the sponsor and/or asset gives rise to both the most prudent, and practical approach. With less sophisticated sponsors in smaller investments, a syndication to friends and family remains the most common execution. Conversely, in the institutional realm, options are significantly more varied.

The availability of equity capital has increased over time due to the now universally accepted premise that real estate, like stocks, bonds and other asset classes, has finally earned a place in the institutional asset allocation model. The implementation of the class into the overall portfolio has seen much deviation both by its magnitude (typical allocations are 5 percent to 10 percent) and the manner of adoption. For the latter, the most common approach is the commingled fund.

The fund model allows investors to underwrite managers and their strategies, but not the assets in which they invest as the sponsor is typically granted full discretion for investment (and divestment) decisions. Most funds fall into two categories. Open-ended funds feature an infinite life, the ability to invest, or request the return of all or a part of their investment on a quarterly basis. The sponsor is compensated by asset management and other fees, but they do not typically participate in profits. Closed-ended vehicles have defined investment, holding and divestment periods. Following the investor's receipt of capital, plus an agreed upon preferred return, profits are shared with the sponsor. This provides sponsors with earnings disproportionate to the original investment, which is known as carried, or promotional interest.

On the other end of the spectrum lies the separate account. In this investment structure, the investor retains all decision-making rights and 100 percent ownership. Although analogous to an asset management relationship operationally, the manager is responsible for sourcing and acquiring assets with the investor's approval.

There are also hybrid approaches to each of these methods of investing. The underlying adoption may be predicated by the investor's confidence and ability to underwrite managers and assets. In a commingled fund, whether open or close ended, the investor is charged only with deciding

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which manager is best. An asset selection decision is typically employed only when an investor is comfortable with their ability to analyze the nuances of a specific investment.

The ultimate determination as to how to best proceed can also fall to investment consultants. Ignoring the size, type and perceived competency of firms, the main distinction is whether consultants have the discretion to make investment decisions or recommendations only. For the former, they become de facto investors and solicitation and servicing by investment managers is comparable to how the actual end-user investor is treated.

The last cycle resulted in a heightened focus on transparency and served to increase the homogeneity of product types and offerings. This leveled the playing field and made choices simpler by reducing the breadth and composition of the options. It is likely that this process will continue as the current cycle duration has resulted in a period of greater circumspection. It will be interesting to see how this impacts the ways in which investors avail themselves of real estate investments moving forward. ■

Jon Dishell is chief business development officer of Gemini Rosemont Commercial Real Estate.

Learn more at www.geminirosemont.com.